DOW THEORY LETTERS.....SPECIAL STUDY.....BEAR MARKET SIGNALS

One of the questions which is constantly asked by readers is "What constitutes a bear signal?" First, let me explain that it is a popular misconception that one must wait for a bona fide bear market signal, under Dow Theory, before selling out. Nothing is further from the truth. In my studies of the procedures of the great Dow Theorists such as Dow, Hamilton, and Rhea, I have found that they seldom waited for an actual bear market signal before selling. They always tried to anticipate such a signal.

THE FORMATION. The actual formation that confirms a bear market is as follows: A secondary reaction (B-C, see chart) lasting about three weeks to three months and retracing 1/3 to 2/3 of the preceding primary advance (A-B) will occur. IT IS WHAT HAPPENS AFTER THIS SECONDARY REACTION THAT IS CRUCIAL. Following the final low point of the reaction there will be an advance (C-D). If, in due time, the two averages go over their previous high point (B) the bull market will be taken as continuing. However, if one or both averages refuse to go over their previous high points (B) and they again decline breaking the low point of the secondary (C and E) on increasing volume we will then say that the bull market has ended and a bear market has begun. After the bear market signal has been given (E) we will then go back and reclassify the entire secondary reaction as the first primary leg in a new bear market (B-C) and the retracement back (C-D) will be reclassified as the first secondary reaction (upward) in a bear market.

WHEN DO WE SELL? If, at the time of the secondary (B), the market is in its third phase (which it is now - see brochure), if values seem greatly inflated, if the technical position of the market is weak, if speculation has been rampant, if the low-priced stocks are booming, if the crowd has participated heavily, we are entitled to at least "guess" that the beginning of any secondary reaction could be the first leg of a bear market. Since greed is the downfall of many investors, we may at that time decide to take our profits. If, after selling out, we find that the bull market is to continue, we can re-enter the market after a bull signal. The commission and taxes paid after selling out will be the cost of "insurance" against a bear market.

We should remember that each successive bullish signal given as a bull market matures has increasingly less validity. Eventually we will be at a spot near the top. Dow Theorists know that at the pinnacle of a bull market the general psychology is optimistic, the economy appears rosy, there are no clouds on the horizon. Shrewd market operators love to unload in this type of setting. And after unloading these investors wait for very depressed prices before buying again. This will be at or near the bottom of the next bear market. On average, bear markets have lasted about one half the length of the preceding bull market. Readers should remember that this bull market started in 1949! Most bear markets have retraced at least one half of the preceding entire bull market. This bull market started at 160 on the Dow-Jones Industrials and 41 on the Rails!